FINANCIAL FEED

2024.Q3

The Evolution, Trends, and Security of Payment Processes

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Bank of Blue Valley

a division of HTLF Bank

FINANCIAL FEED 2024.Q3

Expectations for the future of the economy were for slower growth over the next six months due to uncertainty around the upcoming election, domestic policy, geopolitical conflict and inflation. As your local bank, we look forward to providing insight and helping decision makers manage their businesses with confidence. At HTLF, we've created the Financial Feed to provide our markets with valuable insights on the future of finance. We hope these findings help you conquer potential challenges and capitalize on opportunities.

ON THE COVER

06 THE EVOLUTION, TRENDS, AND SECURITY OF PAYMENT PROCESSES

Explore the rapid evolution of payment processes and the transformative impact of ACH, wire transfers, and commercial credit cards.

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From the Beige Book

Overall Economic Activity

Economic activity maintained a slight to modest pace of growth in a majority of Districts this reporting cycle. However, while seven Districts reported some level of increase in activity, five noted flat or declining activity—three more than in the prior reporting period. Wages continued to grow at a modest to moderate pace in most Districts, while prices were generally reported to have risen modestly. Household spending was little changed this period according to most District banks. Auto sales varied across Districts this cycle, but some Districts noted that sales were lower due in part to a cyberattack on dealerships and high interest rates. Most Districts saw soft demand for consumer and business loans. Reports on residential and commercial real estate markets varied, but most banks reported only slight changes, if any, in recent weeks. Travel and tourism grew steadily and was on par with seasonal expectations. Agricultural conditions varied in tandem with sporadic droughts across the nation. Districts also reported widely disparate trends in manufacturing activity ranging from brisk downturn to moderate growth. Retail restocking spurred slight growth in transportation activity. Meanwhile, tight capacity in ocean shipping led to a surge in spot rates. Expectations for the future of the economy were for slower growth over the next six months due to uncertainty around the upcoming election, domestic policy, geopolitical conflict, and inflation.

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Labor Markets

On balance, employment rose at a slight pace in the most recent reporting period. Most Districts reported employment was flat or up slightly, while a few Districts reported modest employment growth. Several Districts reported declines in employment in the manufacturing sector due to slowdowns in new orders. Skilled-worker availability remained a challenge across all Districts; however, several Districts reported some improvement in labor supply conditions. Additionally, labor turnover was lower, which reduced demand to find new workers. Looking ahead, contacts in several Districts expect to be more selective on who they hire and not backfill all open positions. Wages grew at a modest to moderate pace in most Districts. However, several Districts reported some slowing of wage growth due to increased worker availability and less competition for workers.

Prices

Prices increased at a modest pace overall, with a couple Districts noting only slight increases. While consumer spending was generally reported as showing little to no change almost every District mentioned retailers discounting items or price-sensitive consumers only purchasing essentials, trading down in quality, buying fewer items, or shopping around for the best deals. Most Districts noted that input costs were beginning to stabilize; however, Atlanta specifically noted products like copper and electrical supplies have seen a notable increase over this period.

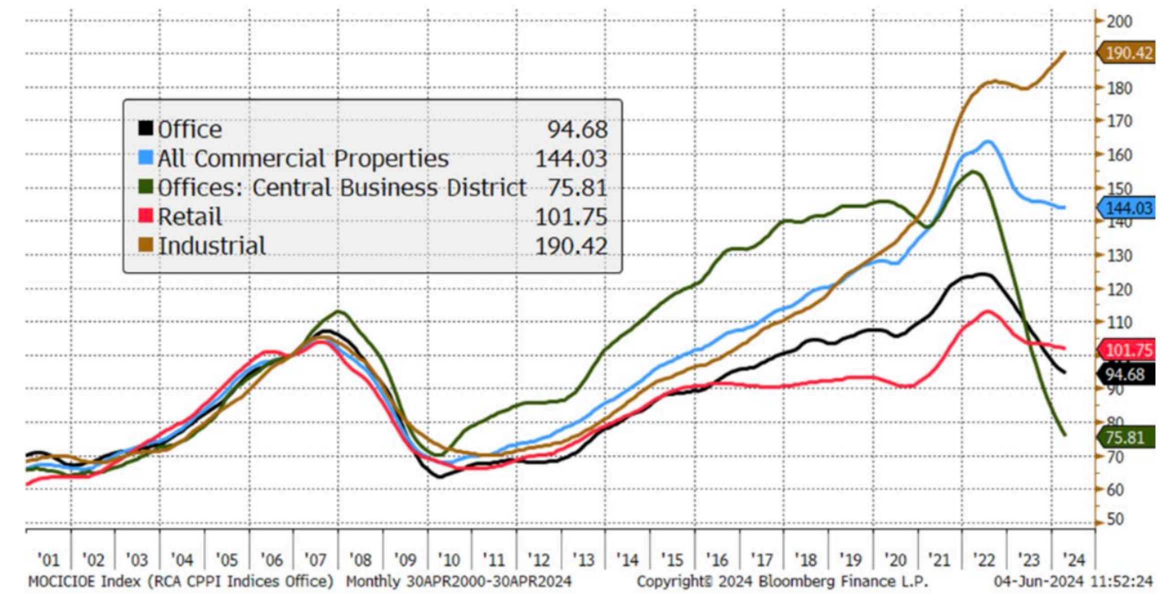
Competing Real Estate Narratives

By Paul Dickson
SVP, HTLF Director of Research

When you hear the words "Real Estate" what comes to mind? The tight housing market where young people seem hopelessly priced out of many of the more desirable locations? Empty offices buildings suffering from the lingering effects of the pandemic and the shift to remote work? Do you gloat over your remaining 20-year mortgage locked in at 3.5% or fret that as much as you would like to move, you simply can't justify a rate close to 7.0%. Is "Real Estate" hot right now? Or does it represent a slow-moving crisis that threatens the outlook for the economy over the coming years?

The competing narratives regarding the property sectors are real, and important. There are simply too few housing units to meet current demand, and affordability is near all-time lows, yet the prices for office properties have plummeted, creating distressed assets and problems for balance sheets from banks to private investors. The headlines for both situations are legion and impossible to ignore.

Commercial Real Estate Price Indices



Real Capital Analytics, April 2024; Bloomberg

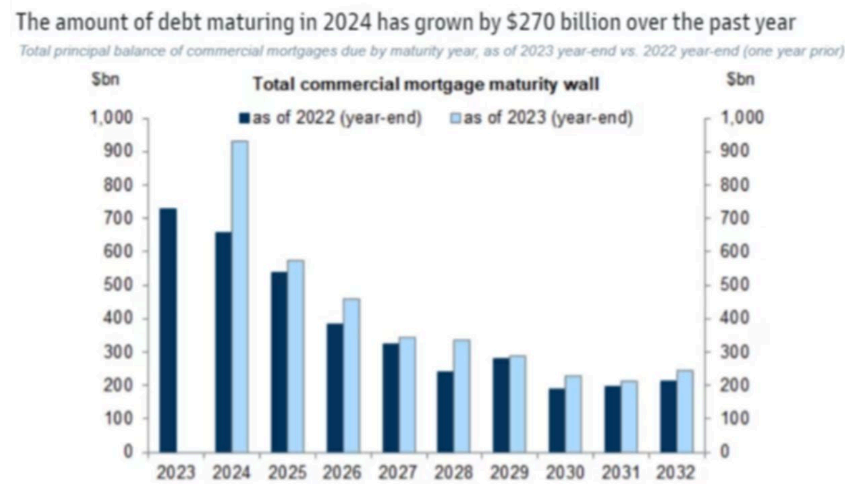
Commercial Real Estate is Much More Than Office Buildings

The headlines bemoaning a looming *Commercial* Real Estate crisis are overly focused on office space where there are clear signs of stress. Looking more broadly other sectors are doing quite well. Public and private sector efforts to onshore production; improve supply chains; and reindustrialize parts of the economy have energized demand for industrial space. These efforts include rebalancing trade post-Covid but also investments directed by the Infrastructure and Jobs Act, the CHIPs act, the Inflation Reduction Act, etc. have sent billions of dollars in investments into industrial space.

Retail property, still weathering changing consumption patterns including the onslaught of on-line shopping, has benefited from the end of pandemic shutdowns and the unleashing of purchasing power from a flush public. As the economy cools and consumers' excess savings are spent, the subsector is also bound to slow. Aside from the occasional firm specific headline, retail on its own appears to be holding up relatively well in comparison. Perhaps this is because of the relative health of these non-office building sectors behind the overall delinquency rate on CRE (Commercial Real Estate) loans. According to the Federal Reserve, the non-office building sector delinquency rate as of the end of the first quarter is below 1.2%. A recent report by MSCI Mortgage Debt Intelligence classified $88 billion of commercial real estate as "troubled', meaning in default or bankruptcy. Given that commercial real estate loans held by commercial banks totals *almost $3 trillion* and not all CRE loans are from banks in the first place, one would be hard pressed to call this a crisis.

Paul Dickson
SVP, HTLF Director of Research

The other term used often is “Survive Until 2025” on the notion that by next year the Federal Reserve (Fed) will be aggressively cutting interest rates. This is expected to be of great benefit to the real estate market, at least in terms of comparative pricing.



Source: Mortgage Bankers Association, Goldman Sachs Global Investment Research

Office Buildings: “Extend and Pretend?” and “Survive ‘til 2025?”

Those figures are for all sectors of Commercial Real Estate where the dispersion of health is, as noted, wide. It is the market for office space where the worries mount. Loan defaults and properties going into receivership or auctioned off for pennies on the dollar compared to their last sale make the news. But if this is a crisis, it seems to be a very slow moving and not very critical one.

One of the reasons the so-called crisis in office space has not been as acute as feared is likely the reality of lender and borrower behavior. Neither are keen on writing down values, taking losses, or going through foreclosure when brighter days *might* be right around the corner. Office workers could return, or interest rates could fall sufficiently to make the situation less grave. This leads to the practice of “extend and pretend” where payments are refinanced or rolled over into the future and rates are left unchanged or repapered at preferential terms. A Goldman Sachs report recently noted that the amount of Commercial Mortgage debt coming due in 2024 grew by $270 billion from 2023 while many future annual totals also rose. This is likely not entirely due to maturity extension, but a significant portion probably is.

The other term used often is “Survive Until 2025” on the notion that by next year the Federal Reserve (Fed) will be aggressively cutting interest rates. This is expected to be of great benefit to the real estate market, at least in terms of comparative pricing. When the risk-free U.S. Treasury rate was near zero, nearly any positive rate of return was attractive. At a 5% risk-free rate, the interest rates needed for speculative lending simply must be higher.

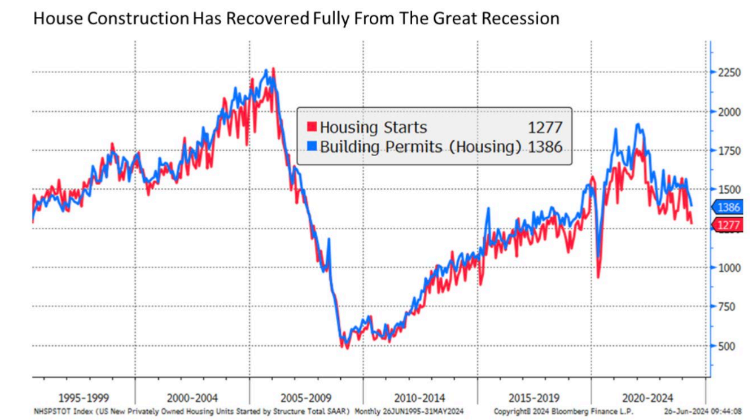
Housing: A Conundrum for The Federal Reserve

The housing market, however, is its own kind of crisis, if in mirror image to that of office space. Since the Global Financial Crisis of the mid aughts the sector has experienced a general underinvestment, creating a supply shortfall estimated in the many millions of housing units. As one would expect that shortfall has meant rising prices for homes as well as for rents.

As shelter is a significant component to official inflation measures (36% of the Consumer Price Index and 16% of the Fed’s Personal Consumption Expenditures Index), rising house prices have had a disproportionate impact. Paradoxically, Federal Reserve policy meant to combat inflation through interest rate increases may have caused house prices to rise rather than fall. Higher rates mean higher construction loan costs that must be recouped, but they also mean higher mortgage rates.

Those higher mortgage rates are supposed to cool the housing market by reducing demand through higher financing costs. However, they have apparently caused a decline in the supply of housing through what is known as the “Lock-In” effect. With outstanding existing mortgages carrying significantly lower rates than current market rates on new ones, many borrowers feel “Locked-In” to their current situation. As the Fed has tried to lower inflation via higher rates, a significant portion of that inflation has worsened, not improved. The Fed cannot build houses, but it can make housing less affordable.

And that brings us to the last chart. According to the Federal Reserve Bank of Atlanta, home affordability is as low as it was during the housing bubble preceding the Global Financial Crisis. The measure includes a combination of inputs, but the most significant ones currently are the higher and rising prices and the higher mortgage rates.



Source: US Census Bureau

If we have a struggling market for office space with depressed prices and a too tight housing market pricing people out of homes, one proffered solution has been conversion of office space into homes. This has, indeed, been taking place in various markets but is hardly a solution on the scale needed. Offices were not built with the plumbing, wiring, openable windows, or other amenities to make conversion easy or cheap. The competing real estate narratives look likely to continue for some time to come barring something to change the current supply/demand dynamics of each.

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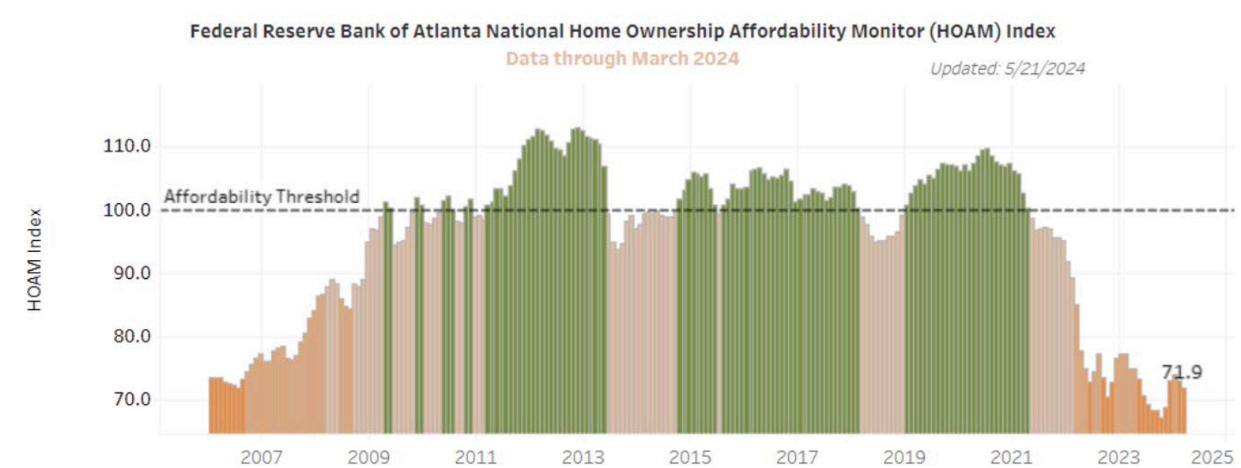

The Evolution, Trends, and Security of

Payment Processes

As each year passes, payment processes change more rapidly, transforming how businesses manage cash and interact with customers. Newer technologies like ACH, wire transfers, credit cards, and instant payments are coming closer to replacing traditional payment methods like paper checks and money orders. Commercial credit cards have also emerged as a key payment solution for businesses, offering greater precision in on-demand payments, improved tracking and reconciliation, automated payment schedules, and enhanced cash flow.

To help you adopt effective strategies and make informed decisions for optimal cash flow management, we explore the evolution of payment processes, current trends, and future directions. We also discuss key considerations for enhancing payment processes and provide fraud prevention strategies.

The Evolution and Future of Payment Processes

The payment process evolution is rapidly changing for both consumers and businesses — and we can expect continued transformation in the future. In the past, payments were often made using traditional paper-based instruments such as checks, money orders, and cash.

The introduction of Automated Clearing House (ACH) payments in the 1970s marked a significant step toward modernizing financial transactions for businesses. ACH enabled rapid and secure electronic funds transfers between financial institutions, offering benefits like:

- Speed
- Efficiency
- Batch processing
- Payment scheduling
- Increased security
- Reduced costs

These benefits made ACH the backbone of electronic transactions in the United States until the late 1990s saw a payment processing revolution. The rise of debit cards and more widespread acceptance of all card types offered international accessibility and benefits like instant payments, cash flow management, and rewards programs. Unlike ACH, which had geographic constraints, debit and credit cards provide global reach, making them indispensable for businesses with international transactions.

Today, we see the emergence of instant payments and technological innovations like blockchain, tokenization, and cloud-based infrastructures. These technologies bring greater traceability and transparency to payment processes.

Instant payments, which allow for real-time processing and immediate funds availability, are becoming increasingly popular. They cater to the growing demand for speed and efficiency in financial transactions, including 24/7/365 processing and settlement. This shift toward instant payments is evident in both consumer and business transactions, providing a competitive edge in today's fast-paced economy.

Today's emerging technologies are driving significant payment processing transformations, providing real-time transactions, immediate fund availability, and dynamic cash flow management. "The ability to pay with precision, the ability to pay on demand, the ability to track a payment from beginning to end — even if it is a day or two — means no longer sticking a check in the mail," highlights Carrie Blankenship, Product Team Leader of Digital Platforms and Payments at HTLF.

Such payment technology innovations reduce fraud risks and enhance security while offering lower transaction costs and accessibility. It's crucial for businesses to stay informed about new payment methods and options in order to make sound decisions about their payment processes. The shift toward digital and instant payments not only improves operational efficiency but also aligns with consumers' and businesses' evolving expectations for quick and reliable financial services.

> "The ability to pay with precision, the ability to pay on demand, the ability to track a payment from beginning to end — even if it is a day or two — means no longer sticking a check in the mail."

Key Considerations for Enhancing Payment Processes

To enhance payment processing, businesses should consider available payment types and the speed and costs associated with each. When evaluating options such as credit cards or debit cards, ACH, and wire transfers, some of the key considerations should be:

- The cost of each transaction
- Payment security technology
- Ease of use
- Execution speed and settlement timing
- Maintenance fees for each account

With a clearer picture of what defines each payment type, your business will be in a better position to decide the most appropriate money movement methods for different types of transactions.

Commercial credit cards, for example, offer speed, security, reliability, extended grace periods, and rewards programs. "Rewards and points are becoming their own critical source of payables and receivables. The ability to pay for business travel with points as opposed to cash becomes almost its own payment network," says Blankenship. Commercial credit cards give companies the freedom to operate with ease while managing their cash flow efficiently.

Strategies for Preventing Payment Fraud

"Fraud, identity theft — those are some of the most disruptive things that we can experience as businesses or consumers," states Blankenship. "Not only is HTLF leveraging the technology and the infrastructure to support security on the business side, but it's equally important for a business owner to do their due diligence on where they are sending money. It becomes a joint effort. Everyone has a role to play when it comes to security and fighting fraud."

While different payment processes include their own inherent security features, businesses must also consider internal strategies to fight fraud.

- Be vigilant when validating vendors and other payees
- Monitor all bank account statements continuously
- Review balance sheets and document transactions regularly
- Train employees to identify fraud and understand safe practices

It's also important to work with established financial service providers that offer security and peace of mind. We prioritize security and customer satisfaction. We work to integrate new technologies and the best security practices, policies, and procedures for compliance and fraud prevention. Our customers can rest assured knowing we are offering the newest and most reliable solutions and technologies to protect businesses from payment fraud.

Businesses need to stay up to date with the latest technology developments affecting payment processes. This is crucial to maintain competitive advantage and create the best customer experience possible for their clients. By staying ahead of these trends and implementing robust strategies, businesses can not only protect themselves from fraud but also enhance their overall financial efficiency and customer satisfaction. HTLF is dedicated to providing the tools and support needed to navigate this evolving landscape confidently.

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My Journey with Digital Payments and Payment Optimization

By Carrie Blankenship
HTLF Product Team Leader of
Digital Platforms and Payments

I've spent nearly my entire career in product management, with the vast majority of my experience in some sort of payment product. In my initial role, I served as a Y2K conversion trainer focusing on card products. That position laid the foundation for my career, where I began by focusing on card payments — mainly debit cards. During this time, I witnessed the genesis of debit cards and how they expanded rapidly in the late 1990s and throughout the early 2000s.

In 2017, I joined SunTrust, which allowed me to participate in the early stages of the U.S. instant payments journey. After the U.S. Faster Payments Taskforce declared The Clearing House to be the most viable solution, I launched The Clearing House (TCH) Real-Time Payments (RTP®) network at SunTrust. I also participated in a number of RTP foundational committees, including the Early Adopter and Operations Committees.

The payment landscape has shifted significantly in the last decade, with digitization speeding up efficiency and precision.

Following the SunTrust merger, I moved to the vendor side, working with Fiserv and a smaller payments FinTech company, Volante. Eventually, Michelle Lance invited me to join the Product team she was building at HTLF, where I now lead the team for treasury and payment solutions digital platforms and payments.

It's amazing to consider how far we've come in such a short time. In 2016, 17 percent of consumers still preferred to pay bills by paper check. However, their use has dropped dramatically in just a few years, with only eight percent of consumers showing a preference for checks in 2022. When ACH came around in the early 1970s, it was supposed to kill the check, just like debit cards were supposed to. But checks are still here. The payment landscape has shifted significantly in the last decade, with digitization speeding up efficiency and precision.

The rate of change now is similar to what we saw in the past thirty years. In this digital economy, people expect things instantly. This demand for immediacy has pushed businesses to evolve from the slow process of mailing checks to instant digital payments.

The Role of Digital Payments in Cash Flow Management

Optimizing cash flow is essential for business success. In fact, as many as 82% of businesses that fail cite poor cash flow management as a contributing factor. Payment optimization is crucial for business efficiency, offering precision and on-demand payments that enhance operational effectiveness. The ability to pay with precision and track payments from beginning to end means businesses can avoid the delays that we all used to experience by mailing checks.

Digitizing payments allows for improved tracking and reconciliation, while automating payment schedules ensures timely transactions. One of the key benefits of commercial card programs is the inherent security features within online banking platforms. These platforms are among the most secure in the world and often provide added features for further protection. Fraud and identity theft are incredibly disruptive, so secure payment processes are critical.

Commercial card programs also improve cash flow through quicker payment cycles and the ability to take advantage of trade discounts. For instance, if a vendor offers a 2% discount for payments made within ten days, then scheduling that payment for day ten can significantly add up over time. Conversely, businesses can take advantage of delayed payment terms to increase their cash flow and strengthen their negotiating position with vendors.

The benefits of revenue sharing programs offered by commercial card programs are also substantial. For example, revenue earned from business travel spending can cover future travel expenses, providing a financial advantage. Revenue sharing can significantly enhance cash flow, offering a nice bonus on receivables that help offset payment costs.

Companies must be vigilant in monitoring debits and credits, understanding the receivables and payables for each account, and staying on top of account activity.

Leveraging Technology for Secure Payments

Improving security in payment processes is crucial for any business, and leveraging technology is key to achieving this. Secure online banking platforms are among the most secure sites globally, run and operated by financial institutions and their technology partners. Still, the Association for Financial Professionals found in a recent study that 80 percent of businesses fell victim to fraud attacks in 2023. Companies must be vigilant in monitoring debits and credits, understanding the receivables and payables for each account, and staying on top of account activity.

To protect against fraud, it's important to be cautious about who you send money to, especially if it's a first-time transaction. Doing a little extra due diligence — like checking vendor ratings and performing reverse phone number lookups — can prevent falling victim to sophisticated fraud tactics. That's why vendor relationship management becomes an important aspect of fraud prevention.

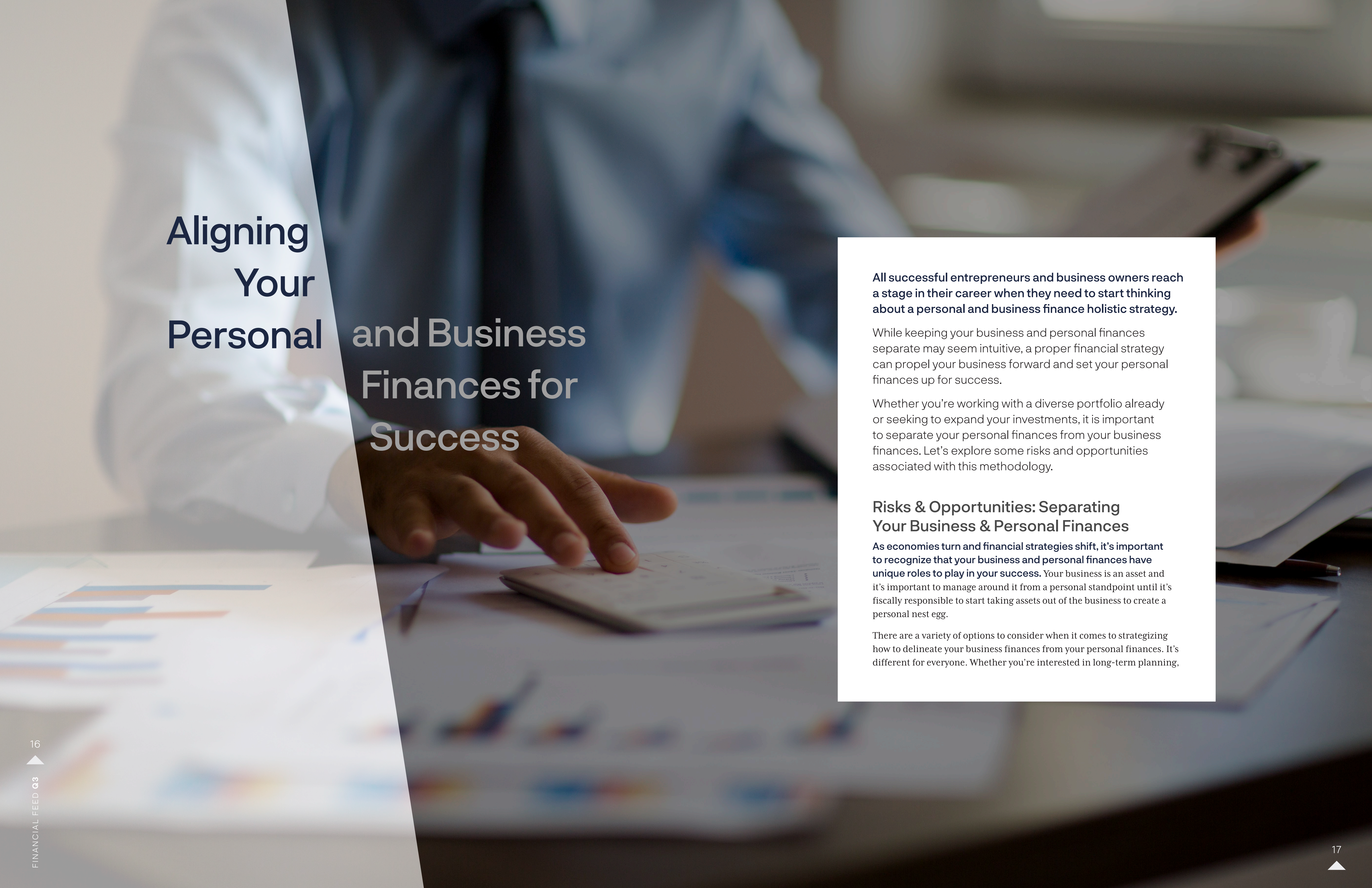
ERP systems and account aggregators also play a significant role in secure business payment strategies. Platforms like NetSuite, Dynamics, and even QuickBooks manage accounts payable and receivable, integrating seamlessly with banking systems. These systems help businesses efficiently handle invoices and payments, enhancing both security and operational efficiency. By aggregating data, these platforms enable a holistic view of financial activities, which is critical for fraud prevention in payments, cash flow optimization, and overall business security.

At HTLF, we're committed to investing in technology to enhance security and protect our customers. Our ongoing efforts include integrating with various platforms that our customers use, ensuring we provide a secure and seamless experience. Fraud prevention is most effective when we have comprehensive data, including payment and vendor information. The more data we have in one place, the better we can protect our customers' assets and provide secure, efficient payment solutions. This commitment to security and customer protection is a cornerstone of our services, ensuring that businesses can operate confidently in an increasingly digital world.

Maximizing Business Potential with Modern Payment Solutions

Commercial card programs offer a powerful tool for optimizing cash flow and enhancing security in today's fast-paced business environment. By capitalizing on digital payment benefits like precision and on-demand capabilities, businesses can streamline operations, improve tracking and reconciliation, and automate payment schedules. The secure nature of these transactions helps reduce fraud risk, providing a stable financial environment.

As we look to the future, commercial card programs will continue to play a significant role in business expansion. At all HTLF divisional banks, we protect our customers by adapting to the financial world's rapid changes, such as instant overseas payments and blockchain and tokenization, which will significantly affect current currencies and procedures. Businesses must embrace these changes to achieve their full potential and ensure their longevity and prosperity for years to come.



Aligning Your Personal and Business Finances for Success

All successful entrepreneurs and business owners reach a stage in their career when they need to start thinking about a personal and business finance holistic strategy.

While keeping your business and personal finances separate may seem intuitive, a proper financial strategy can propel your business forward and set your personal finances up for success.

Whether you're working with a diverse portfolio already or seeking to expand your investments, it is important to separate your personal finances from your business finances. Let's explore some risks and opportunities associated with this methodology.

Risks & Opportunities: Separating Your Business & Personal Finances

As economies turn and financial strategies shift, it's important to recognize that your business and personal finances have unique roles to play in your success. Your business is an asset and it's important to manage around it from a personal standpoint until it's fiscally responsible to start taking assets out of the business to create a personal nest egg.

There are a variety of options to consider when it comes to strategizing how to delineate your business finances from your personal finances. It's different for everyone. Whether you're interested in long-term planning,

Whether you're interested in long-term planning, tax benefits, or protecting the shares of your business, everyone's strategy is unique. That said, if you haven't separated your personal and business finances, you may not realize the legal and financial risks.

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If someone takes you to court, and your business and your personal finances are directly tied to your business, it could impact you more directly. On the contrary, if the stock market has a poor quarterly performance, and your personal investments are funding your business operations, your business can suffer the loss just as much as you do.

Private banking offers clients the ability to focus on their business and personal finance strategies as separate but unified approaches. HTLF has the ability to present options for long-term planning, asset reallocation, and liquidity management services. While the strategy for business and personal finances remains separate, we recognize that our clients are managing both with equal priority. At HTLF, we take the time to understand our clients' goal and create a plan that works toward it.

How the Economy Affects Your Personal and Business Bottom Line

As the economy shifts, our team recommend different strategies to keep your finances resilient. Whether the economy is experiencing growth or recession, future-proofing your strategy helps weather unexpected shifts in the market. As you experience more and more success in your personal and professional life, you'll need to find ways to safeguard your financial strategy.

With the full spectrum of financial services under one umbrella, HTLF is poised to provide effective, all-encompassing strategies to business owners.

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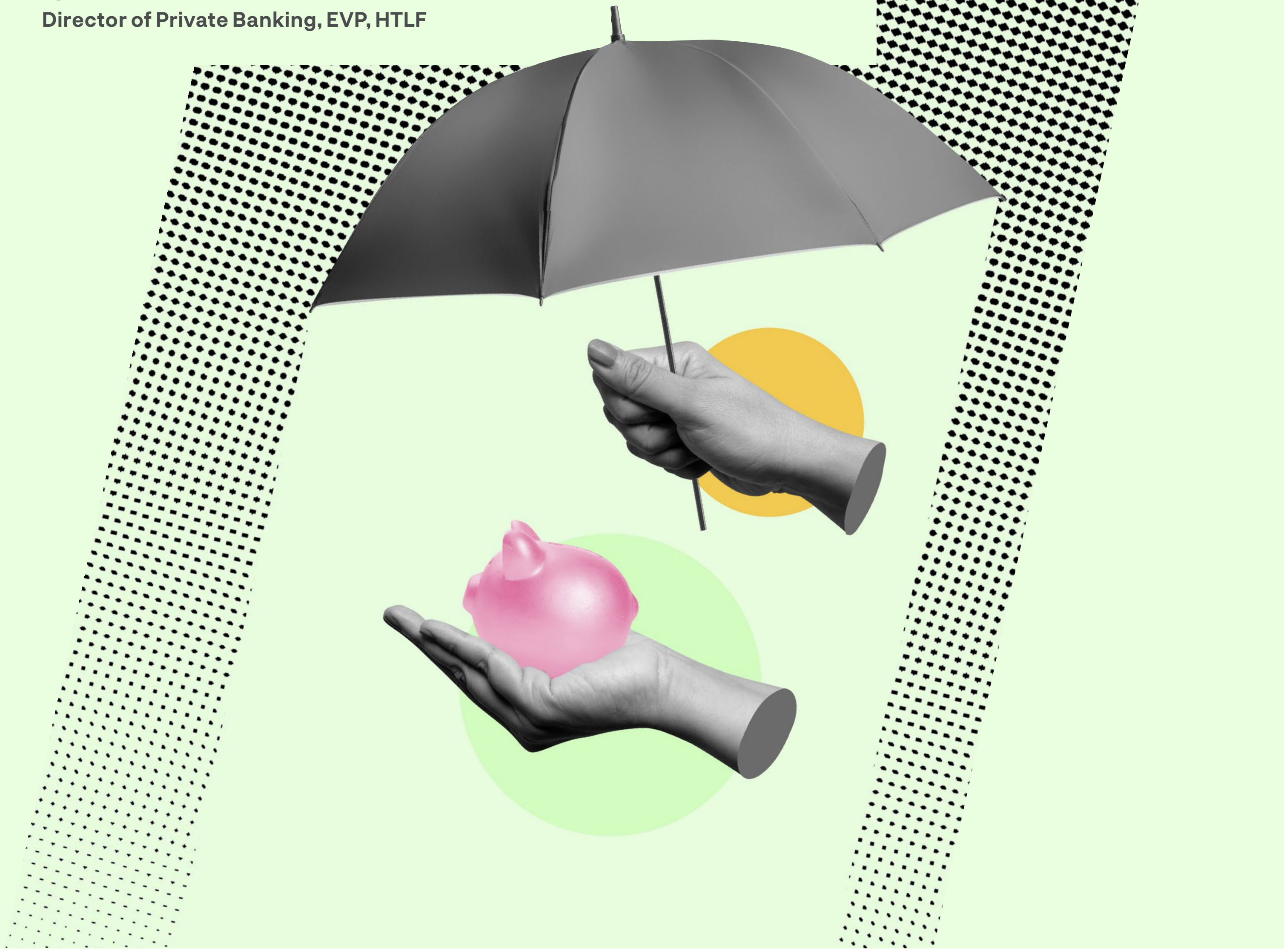
EXPERT
COMMENTARY

Private Banking for Business Owners

By Kevin Zimmermann
Director of Private Banking, EVP, HTLF



Whether you're an entrepreneur or a business owner carrying on your family's legacy, there comes a point in time when you'll need to evaluate your business' growth strategy. As your business pivots with the continuous market shifts, a trusted financial partner is crucial to help you understand the economic impact.

Private banking is designed to help high-net-worth individuals manage their money. Many of our clients that are business owners have diverse portfolios. We also have had the opportunity to work with multiple foundations and non-profits as well.

Economies turn, financial times are different, so we advise our clients to treat their business as an asset. When we work with clients, we manage the business as an asset for both professional and personal growth.

Economies turn, financial times are different, so we advise our clients to treat their business as an asset. When we work with clients, we manage the business as an asset for both professional and personal growth.

We work with clients to evaluate at what point it may be fiscally responsible to begin taking assets out of their business. This can help build a nest egg on the side. In addition to that, we can help you consider long-term planning tactics that support this strategy. This could include incorporation of your estate planning strategy into your business plan.

From my 20+ years of experience in this industry, most entrepreneurs and business owners who end up selling never really scratched that entrepreneurial itch. They often want to go out and do more. It's important that my team identifies what our client's needs are and how we can help fulfill their goals.

In this scenario, often times, wealth has been built up and there is a want to preserve it, but also a drive to continue the entrepreneurial journey. My team creates customized options – Whether it's loans that help our clients buy into another operating entity, starting up another company of their own, or helping them fund their children's goals, we make sure we're doing it with them as a partner.

As our clients navigate shifts in supply and demand, transition ownership of operating responsibilities, or pass the torch altogether, we are there as a partner to help them reach their financial goals and continue to build their wealth.

Kevin Zimmermann
Director of Private Banking, EVP, HTLF

With the power of private banking and our middle market commercial bank, allows us to offer services comparable with other larger financial institutions in the market, while delivering in a client-centric way.

One of the things that brought me to HTLF was our ability to show up in each one of our distinct markets as a community bank. The home-grown community bank environment provides a sense of security and trust, and we continually earn that with our clients.

When you walk into one of our banking centers, you receive a one-on-one personal service. You're greeted, walked to a teller line and communicate with a banker who takes the time to get to know you. Together we provide trust and comfort in a community setting, and that in-result creates an incredible experience.

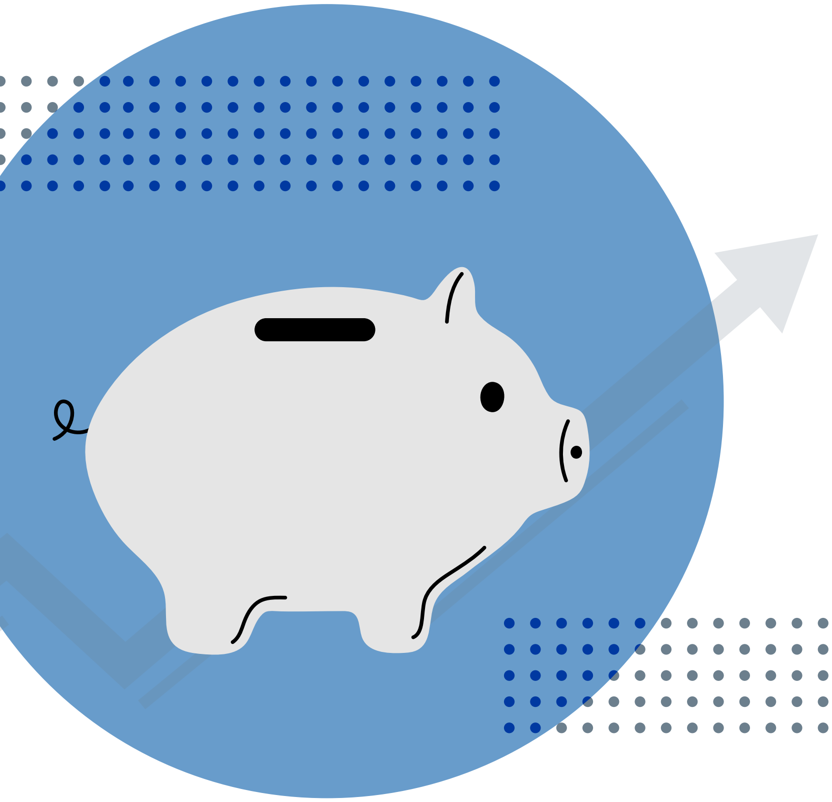
Now, when combining that quality of experience with a larger $20 billion organization like HTLF, we have capabilities that many of the small banks don't. This provides our clients with more product solutions, conveniences and lending opportunities.

With the power of private banking and our middle market commercial bank, allows us to offer services comparable with other larger financial institutions in the market, while delivering in a client-centric way.

We believe in having a collaborative conversation. When meeting with our team, we can engage portfolio managers and wealth advisors from HTLF Wealth Management discuss incorporation of your estate planning strategy into your business plan. This ensures that no matter what your financial journey may look like now, we are built to be agile as it evolves.

When clients call us, it's their Private Banker who picks up the phone. We take the time to develop relationships and foster that trust by showing up for them time and time again. ▲

Products offered through HTLF Wealth Management are not FDIC Insured, are not bank guaranteed and may lose value. HTLF does not provide tax, legal, or accounting advice.



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